The Ag Bank's Turnaround: From Insolvency to Profits

Final Report of the EPSP's Technical Assistance to the Ag Bank of Mongolia

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I. BANKING-SECTOR HISTORY AND THE AGRICULTURAL BANK (AG BANK) BACKGROUND

The Mongolia financial system is dominated by commercial banks. Prior to 1990, Mongolia had a monobanking system administered by the State Bank. The bank performed both central-bank and commercial banking functions, but its main purpose was to transfer government resources to public enterprises. When it extended loans, the bank used no due process of risk assessment, project screening, or selection against a reasonable collateral value. In addition, the aggregate credit amount was centrally determined.

In 1991, the monobanking system was replaced by a two-tiered banking system. Five banks (the People's, Insurance, Agricultural, Industrial, and Cooperative banks) devolved from the divested portfolio of the former State Bank, and nine new banks were created. In April 1991, the Banking Law was passed, establishing the new central bank, called the Bank of Mongolia (BOM), and providing licenses for new commercial banks.

Despite the increase in the number of banks, Mongolia's banking sector was highly concentrated. In 1994, the five large banks accounted for, on aggregate, 94 percent of total system deposits and 89 percent of total loans, while the small banks, on a combined basis, had a deposit base smaller than that of the smallest of the five large banks.

The ownership structure of banks was diverse at this time, as shown in Table 1, which shows the status of the country's banks as of January 1997. Banks were spun off from the monobank by granting equity shares to enterprises and cooperatives, which may have later resold the shares. These banks were then privatized when their owners were privatized. Because the shares were not purchased, however, shareholders often had little interest in corporate governance beyond dividends. Therefore, they did not pressure management to manage assets responsibly as shareholders normally would.

Since the establishment of Mongolia's two-tiered banking system, several banks have failed. The first banking crisis occurred in September 1994, as a result of insolvency from fraud and bad loans. The Government of Mongolia forcibly merged two troubled small banks, the Cooperative and Selenge banks, with two large banks, the People's and ITI banks, and provided highly subsidized loans to cover the cost of the mergers.

During this period, the Ag Bank was also in trouble. It inherited 337 branches and 2,600 employees from the monobank network. Although its shareholders were privatized, it never operated as a private-sector entity. Branches operated as appendages to local governments, with pension and salary payments made for the government without compensation, and some aimag (provincial) governors continued to make decisions to hire and fire branch managers. Most of the inherited loans were nonperforming, and loans extended after 1991, mostly to state-owned entities, were not paid back. Political authorities, such as governors and members of Parliament, were given loans, most of which were extended with the understanding that they would never be paid out. Generally, 20 percent of the loan amount was paid out in bribes, which could be broken down as 10 percent to branch managers and 10 percent to government authorities. Even nondirected, noncorrupt loans were a problem because of a lack of credit analysis.

Table 1: Structure of Mongolia's Commercial Banks, January 1997

Physical				Share of Ownership				
Commercial Banks	Established	Offices	Employees	Gov't.	State-Owned Enterprises	Private	Individual	Co-ops
Reconstruction	Dec. '96	---	---	100.0%	---	---	---	---
Savings	Dec. '96	---	---	100.0%	---	---	---	---
T&D	Jan. '91	3	79	100.0%	---	---	---	---
ITI	Nov. '90	74	726	---	78.8%	21.0%	0.2%	---
Agricultural	Dec. '91	358	2,590	7.6%	---	41.3%	0.5%	50.6%
Mongol Post	Mar. '93	1	12	11.6%	---	58.5%	29.9%	---
Export-Import	Jun. '93	1	22	---	---	28.6%	71.4%	---
Industrial	Dec. '91	2	28	---	2.0%	69.7%	26.3%	2.0%
Business	Mar. '93	1	10	---	---	85.6%	14.4%	---
Mercury	---	---	---	11.0%	---	79.7%	8.4%	0.9%
Golomt	Jun. '93	1	23	---	---	---	---	---
Bayanbogd	Oct. '92	1	11	---	---	---	100.0%	---

Source: BOM, 12/17/96

In the summer of 1996, the banking sector was hit by another crisis. Two additional small banks were closed down because of insolvency, prompting widespread deposit withdrawals. Public confidence in the banking system eroded, and the BOM injected volumes of liquidity in response. In December 1996, the government closed down two more insolvent banks, both large, the People's and Insurance banks. Also, it enacted two laws, the Central Bank Law and a new Banking Law. It then created three new institutions, the Savings Bank, the Reconstruction Bank, and the Mongolian Asset Recovery Agency (MARA). The Savings Bank was established to invest only in safe assets to support its deposits, composed mainly of retail deposits of the closed banks. The Reconstruction Bank retained all the performing loans of the two liquidated banks and lent only to nondefaulting enterprises. MARA, on the other hand, within three years was to aggressively collect small-scale nonviable loans to individuals. Meanwhile, the BOM signed memoranda of understanding with the owners and senior management of two other troubled large banks, the Ag Bank and the ITI Bank.

The Ag Bank was deep in losses by 1996. Since 1995, it had been insolvent because it had been unable to collect its loans. Investor capital and US$4.2 million from the Asian Development Bank covered the losses; however, underlying structural and procedural problems, such as bad credit, poor corporate governance, and poor accounting practices and auditing, were never addressed. In addition, the German Technical Cooperation (GTZ) started its loan program through the Ag Bank. In 1997, the government paid the Ag Bank MNT 6.0 billion for past delivery services of pension and salary. It also promised to pay MNT 30 per transaction but never followed through.

In 1998, the next banking crisis began. It continued into 1999 because the government stopped servicing bonds because of budget problems. The banking sector was facing illiquidity problems, forcing the Savings Bank to become illiquid. Because banks were free to set their own interest rates for deposits and loans, the Savings Bank raised its interest rates, forcing up already high rates in the market as a whole. Moreover, in 1998, nonperforming loans had risen to 41 percent of all loans.

Meanwhile, the Ag Bank, which had not had a profit since 1997, still had not recovered by this time. In December 1998, its assets were MNT 7,738 million, while its liabilities exceeded assets by MNT 4,001 million.

In the last quarter of 1998, the government took several steps to improve the banking sector. It amended the Banking Law to strengthen the regulatory framework for banks and raised the minimum capital requirement from MNT 400 million to MNT 1 billion. This was meant to contract the banking sector, as seven small banks did not meet the requirement. (The BOM withdrew the licenses of two of the banks.) Also at this time, a new accounting standard became effective, balance sheet disclosure improved, and guidelines for certifying auditing were made clearer.

Despite these measures, the banking sector was again in turmoil by 1999. Three large banks, the ITI, the Reconstruction, and the Ag, were all insolvent. In February, they were placed under conservatorship, and by the end of the year, the Reconstruction and ITI were closed down. The liquidation of these banks reduced the size of the sector by a fifth. Prior to the closedowns, 4 banks out of 12 held 80 percent of total assets, and the government had stakes in six banks and controlling interest in three: the Savings Bank, the Trade and Development Bank, and the Ag Bank.

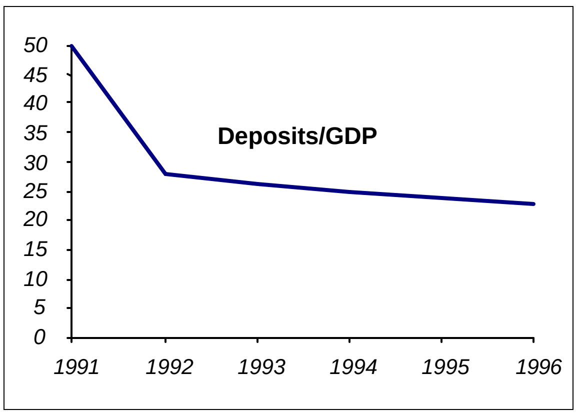
In 1999 and 2000, extremely cold winters caused losses approximating US$30 million. As a result, 8 of 20 banks were liquidated. By this time, the Ag Bank was again hit by problems. In 1999, the government fell behind on its pension and salary payments of MNT 2.3 billion and caused more liquidity problems for the bank. In February of that year, the bank's liquidity ratio was -2.6 percent.

The reasons Mongolia's banking system faced major financial crises throughout the 1990s originated from the problems within the banks and a lack of decisive government action. By the mid-1990s, the banking system experienced significant deterioration because it became illiquid as a whole. Total liquid assets (cash, bank reserves, and central-bank bills) fell from MNT 13.4 billion in 1995 to MNT 6.9 billion in 1996, a 68 percent real decline. Moreover, banks had more loans than deposits, which was senseless, especially considering their liquidity problems. Money circulating outside the system increased (see Figure 1, bar chart top right) because of low confidence in the banking system and the rise in a sizable unofficial money market.

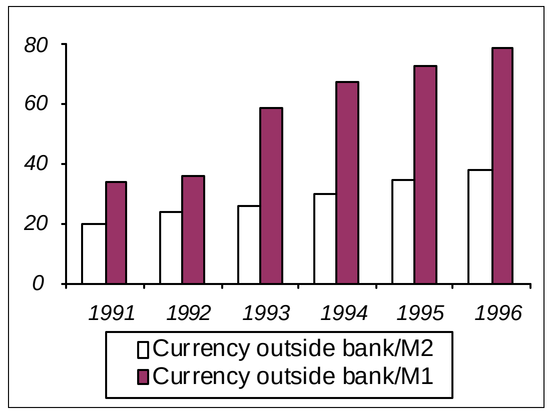
Overall, cash represented a large share of the money stock. Therefore, it was evident that the banking system had developed disintermediation. Moreover, public confidence in banks was very low, as noted above, and depositors kept their money outside of the banking system's circulation. Banks were unable to maintain adequate reserves in the central bank; more and more, they relied on BOM funding and government deposits. More than 50 percent of the banking system's total loans outstanding were nonperforming at the end of 1996. Because the loan-loss provision process was very weak in Mongolia, interest continued to accrue on defaulted loans overdue beyond 12 months. There were almost no formal write-offs, as they were regarded by borrowers and the legal system as a recognition of elimination of the claim against the borrower.

Figure 1: Anatomy of a Banking Crisis, 1991 to 1996

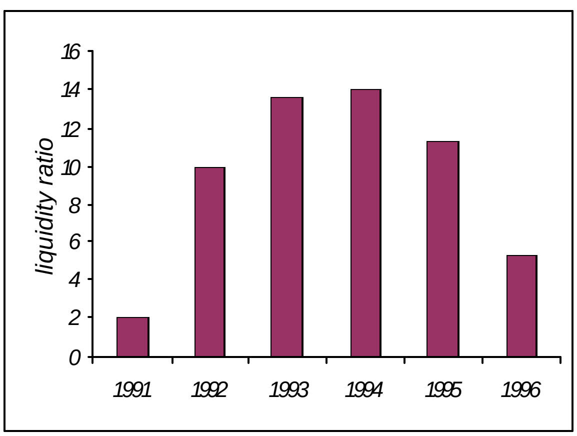
The banking system faced financial disintermediation:



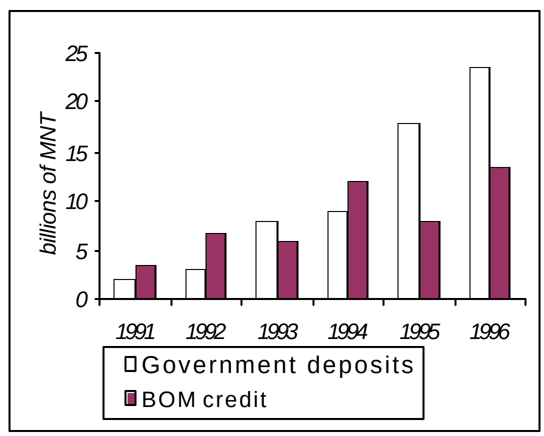
Currency in circulation outside the banking system increased:



Liquidity within the banks decreased mid-decade:



This required banks to rely increasingly on government deposits and BOM credit:



Note: M2 = Broad money supply (narrow plus time and savings deposits);
M1 = Narrow money supply (currency plus demand deposits).

The Ag Bank that operated in this distressed system continued to be one of the troubled banks. After being taken under the BOM's conservatorship, its lending was suspended, operations cut back, and only payment services preserved. Because of its liquidity problems, the Ag Bank had problems with payments. By this time, private shareholders had been wiped out and the government had assumed full ownership of the bank. All 6,431 shareholders (56 percent private-sector entities, 33 percent individuals, 8 percent state entities, and 3 percent state joint ventures) had lost their stakes in the bank. A large bank run had occurred until the government guaranteed deposits in August 1999. Two months later, the bank was placed under receivership. Therefore, although it kept its doors open, the Ag Bank had closed all banking services except for very basic ones. Withdrawals were allowed because of the public mistrust, but deposits were very rare.

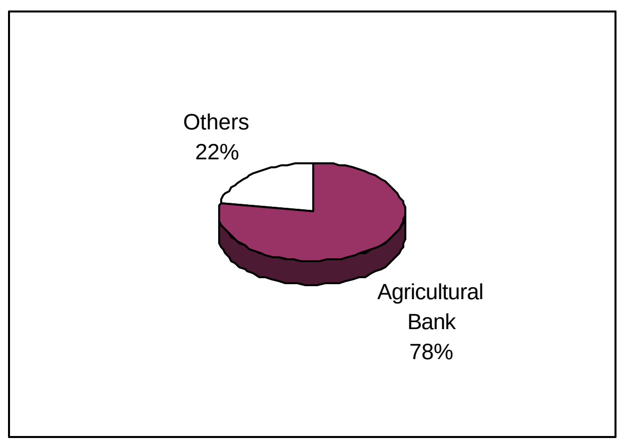
During this time, the bank had to cut its branches and employees. All soum (county) branches nearest to aimag center branches were closed down, 337 branches were reduced to 269 branches, and staffing was reduced from 2,600 to 803. Losses were cut to US$50,000 a month. (The bank had losses of US$4 million in 1999 and US$300,000 in 2000.) It was evident that the time had come to decide what to do with the Ag Bank.

II. RURAL FINANCE AND THE AG BANK

The Ag Bank could have been liquidated like other troubled banks that were closed down in Mongolia in the 1990s; however, it was the only bank in the country that had branch offices in most soums. Mongolia has 22 aimags, or provinces, which are divided into 320 soums, or counties, excluding aimag centers. Bank presence in the aimags is generally limited to three to five branches in the aimag centers. The Ag Bank was the soum branch provider, except in Hovd, Selenge, and the three urban aimags, Ulaanbaatar, Darkhan, and Erdenet.

Ulaanbaatar contains a third of Mongolia's population, and its market in the 1990s was a net provider of funding for rural financing because it was home to the vast majority of all enterprise headquarters. The typical banking office in rural areas had many small accounts with volumes too small to cover costs. Because the Ag Bank had access to most of the rural areas, it was particularly hard-hit by the problems of having a small customer base. It had the largest number of branches in soums, and its offices primarily took deposits, distributed pension checks without any compensation, and mostly did not lend. Therefore, despite having an extensive network throughout Mongolian rural areas (see Figure 2) and being the only banking facility in the soums, almost all of the Ag Bank's offices lost money.

Figure 2: Bank Offices in Rural Areas



Source: Ag Bank, 12/31/01

Nonetheless, providing banking services to rural and remote areas, where almost 70 percent of Mongolia's population is spread out, was essential. The rural economy as a whole had been weak, and small and medium-sized enterprises lacked both investment and working capital. Furthermore, there had been no major value-added economic activities in rural areas. Agriculture and small time trading were the only activities, and all soums produced essentially the same products, restricting their trading. These factors limited economic growth in these areas, emphasizing the importance of having financial tools in these regions to support development.

On the other hand, most important for the government, the Ag Bank served the purpose of delivering pensions and payments in the countryside. At one point, when the bank was illiquid, the State Social Insurance General Office had conducted a study to determine whether it could distribute pensions without the bank's network. It turned out that this would have cost the office a large amount of money that it could not afford. Therefore, it was in the government's interest to recapitalize the bank instead of liquidating it if adequate financial support for the rural areas was to be assured.

III. MEMORANDUM OF UNDERSTANDING AND CONTRACT

The United States Agency for International Development (USAID) assisted in assessing the Ag Bank's condition, and the Mongolian government began discussions on what to do with the bank. Various donor organizations, including the World Bank, Japanese International Cooperation Agency (JICA), and the Asian Development Bank, examined the financial sector and rural finance at the end of the 1990s. Because the Ag Bank was near insolvency at the time, they determined whether recapitalizing it would be the best option. All but one organization recommended that the bank be liquidated in its entirety or restructured.

Nevertheless, the government decided to recapitalize the bank, which had a nationwide network to mobilize rural savings and help the rural economy through lending and other financial services. The governing documents of the recapitalization, restructuring, and rehabilitation were a memorandum of understanding (MOU) between the government and the BOM, and a management contract between the bank's board of directors and the hired management team provided by Development Alternatives, Inc., (DAI) under the USAID-funded Economic Policy Support Project. These documents provided a set of safeguards and could not be easily changed because the World Bank made reforming the Ag Bank a condition of the former's Financial Sector Adjustment Credit (FSAC) Program for Mongolia.

The MOU, which was signed on June 23, 2000, reflected the World Bank FSAC conditions approved in April 2000. The main objectives were:

? Restoring the Ag Bank's ability to provide rural Mongolia with financial services;
? Restoring financial soundness to the Ag Bank; and
? Preparing the Ag Bank to operate independently and be privatized.

Moreover, there were several conditions for the MOU:

? The government would recapitalize the bank, with the government and the BOM depositing MNT 3.4 billion that would be converted into capital. The government would also issue MNT 4.2 billion in restructuring bonds to annul the negative capital. As a result, this recapitalized successor bank would be wholly owned by the government as represented by the State Property Committee (SPC).

? After the government's takeover, a time-bound program of rehabilitation would be instituted to accomplish the above objectives. A two-year management contract team of foreign and local experts would be created to work at the bank. This management team would make the Ag Bank commercially viable and train a team to take over the bank at the end of the contract.

? The government would be liable to develop and initiate a privatization plan before the end of the two-year management contract.

The responsibilities of the government included the following:

? Issuing MNT 4.2 billion in restructuring bonds, with a maturity of five years and monthly interest not less than 70 percent of the central bank's bill rate;
? Paying the bank MNT 600 million for past payment and pension services with MNT 100 million monthly starting from the date of the management contract;
? Developing a new charter in line with the new government ownership;
? Appointing a chief executive officer (CEO) and management team to run the bank for not less than 24 months;
? Appointing a five-member board of directors (BOD) comprising representatives from the SPC and the Ministry of Finance, the CEO and the chief operating officer of the bank, and an individual chairperson; and
? Reviewing the changes with other stakeholders every six months.

The most important part of the arrangement was that during the two-year remediation effort, the team would report to an independent BOD because the Ag Bank's past failures could be traced to government interference in its business. The BOD was required to ensure that the government, the owner of the bank, did not interfere in the institution's operations. The board was also supposed to monitor implementation of the plans and agreements to develop a new charter. Finally, it was also responsible for reviewing and approving a new business plan supportive of a privatization.

The BOM was responsible not only for monitoring the MOU conditions, but also for determining whether all rehabilitation steps were in compliance with banking laws and regulations.

The entire MOU was reviewed and agreed to by the Government of Mongolia, the BOM, the World Bank, the International Monetary Fund (IMF), the Asian Development Bank, and USAID. The donors insisted that an external management team be placed in charge of the bank for a two-year, time-bound remediation period. USAID ultimately agreed to provide funds for an outside management contract.

The management team was responsible for implementing plans and agreements, operating strategy, and business plans; developing a two-year program to take the required rehabilitation steps; training managers in corporate governance; and improving policies, procedures, and controls regarding lending, internal controls, auditing, and risk management. The team was also assigned to review and solve information technology–related problems; create a performance-based compensation plan; control staff and business-unit decisions; ensure compliance with laws and regulations; and hire a firm to conduct external audits.

The management contract was drawn up to be effective for two years and could be canceled at the request of any of the stakeholders, or if management failed to reach the financial objectives. According to the contract, in addition to the above responsibilities, the management team was to ensure that the financial objectives were met. If for some reason the underlying financial assumptions were to change, management was obligated to inform the Ministry of Finance and submit the changes in the financial objectives to the ministry and the BOM.

The financial estimates governing the management contract were based on the financial assumptions within the MOU. Minimum capital was estimated to start at 0 and grow after December 2000; positive income on a quarterly basis was to start only in September 2001. The balance of loans prior to recapitalization was to start at MNT 576 million and decline to 0, and the capital risk–weighted asset-sufficiency ratio was to start at 0 and increase to 8 percent over the course of the contract. Moreover, the balance of OREO (other real estate owned) prior to recapitalization would start at MNT 338 million and decline to 0 over the course of the contract. Total nonperforming loans based on loans made subsequent to recapitalization as a percentage of new loans would start at 0 and be allowed to grow to 5 percent and then to 10 percent.

The contract was signed with DAI of Bethesda, Maryland, to manage the bank. Funding was provided by USAID, and an external management team took control of the bank in August 2000. DAI, under USAID, brought in J. Peter Morrow, chief executive officer, and Debra Boyer, chief operating officer, to manage the bank on a full-time basis.

IV. Governmental Factors

On July 2, 2000, slightly more than a week after the MOU was signed, Mongolia held its national elections, during which the Mongolian People's Revolutionary Party (MPRP) defeated the Democratic Party.

Originally, the MPRP looked to the Ag Bank to be a "development bank" that functioned as an adjunct to the government, and it considered developing a government-sponsored institution to undertake rural finance. Such a strategy, however, would have introduced difficulties into the financial market. Scarce financial resources would have been diverted to unproductive sectors and enterprises, depriving more-creditworthy borrowers. Moreover, a government-sponsored bank could have proved a formidable competitor to private lenders and would have crowded competitors out of the most productive relationships. Economically, it is better to encourage competitive private-sector initiatives than to apply government resources without mitigating the underlying risks. Any government participation in rural lending should be clearly reflected in the budget, in order to limit its scope and maintain its transparency. Therefore, one of the main factors in the Ag Bank's future success would be management's ability to find a successful resolution to the political influence that dominated the bank for years.

V. CHALLENGES

In addition to keeping the Ag Bank independent from government influence, the management team had many other challenges ahead if it was to achieve the bank's turnaround. For one, Mongolian risk assessment of loans and lenders was so bad that some donors suggested that the bank be remediated without lending. The bank lacked an effective credit policy, and poor risk assessment by bank lenders and poor credit decisions by senior bank management had led to significant loan losses. Moreover, senior bank managers had not been adequately held accountable for their lending activities. "Ordinary" people had rarely been able to borrow from the bank, and most of the loans in the past went to the government with no pressure to repay. A new credit culture had to be developed, one that would change lending managers' and customers' perceptions of credit. Credit managers would be held accountable for their lending decisions, and borrowers would understand that the bank's lending program would be fully transparent and accessible to all who qualified.

Another challenge was to pilot new loan and deposit strategies and products to capture the bank's target market, build fee income, and improve cash flow. Rural areas had seasonal credit needs: herders had substantial amounts of cash in spring from cashmere sales and in autumn from meat sales. Other months, they had no income and suffered a gap between their living and operating expenses. Thus, the bank needed to offer loans to accommodate the seasonality of rural herding.

The bank also faced a problem with deposits. Mongolians traditionally had not used bank accounts for savings or payment transactions. The bank therefore needed to improve its customer service and introduce new services to attract depositors and encourage people to open accounts.

Yet another obstacle was the existing perception of the Ag Bank. Surveys showed that 70 percent to 90 percent of the rural population wanted to use banking services such as deposits and payments but did not because of a lack of trust. The bank was still seen as a politically driven organization. Marketing was urgently needed to improve the bank's image.

Moreover, although the bank's staff was well-educated and good at performing many day-to-day banking tasks, the bank still had too much of a "state-sector" mentality. A new culture needed to be developed that encouraged staff to be revenue-driven and customer service–oriented, combined with strategies that harnessed their skills.

The final challenge was to stabilize the bank so it could sustain itself using its own profits. The bank's infrastructure needed to be reorganized and a successor management team developed and trained so that the bank could be successfully privatized and become self-sustaining.

VI. STRATEGIES

In order to maintain the Ag Bank's independence, the management team informed government officials that management was fully entitled to control the bank. The team made every effort to make officials understand the need for an independent Ag Bank board and external management, and that USAID funding and the external contract would end, jeopardizing the US$32-million FSAC loan for Mongolia's financial sector. DAI management continued to emphasize to the government representatives on the BOD that they were required under the MOU to keep the bank independent of the government. Finally, in December 2000, management negotiated its relationship with the government. Although initially suspicious, the government eventually supported the remediation fully and committed itself to the bank's independence.

To change the bank's credit culture, management held the branch managers completely accountable for the decisions they made. Additionally, zero tolerance was given to politicians locally or nationally who tried to influence lending. It was easier to impose this policy than it would have been in the past because the external management team was running the bank. New policies and procedures were introduced to ensure that loans were not being made to customers who were not paying them back. Further, the loans were structured to make them easier to pay back. Everything was standardized to make the procedures easy to implement and follow at all levels, and intensive training was conducted to improve the loan-assessment process.

A loan strategy was put in place to meet the needs of a large segment of the market, ensuring diversification by product and geographical area. The goal was to pilot quickly new products and then rapidly expand their delivery throughout the countryside. The Ag Bank developed targeted loans, made in small amounts and to many borrowers (see Table 2), and continuously trained staff to monitor proper loan implementation intensively. All loans were tied to specific cash flow and fully secured, allowing meaningful penalties for nonpayment.

Table 2: Ag Bank Loans, as of December 31, 2002

Loan Product	Date Product Launched	Total Number of Loans Disbursed	Total Value of Loans Disbursed ($000)	Total Number of Loans Outstanding	Total Value of Loans Outstanding ($000)
Small business	Nov. 2000	49,389	$57,452	11,172	$14,080
Pensioners	May 2001	286,420	$15,955	47,497	$2,803
Herders	Aug. 2001	10,034	$8,332	3,081	$2,874
Payroll-based	Oct. 2001	52,537	$11,346	21,956	$4,160
Other	2001/2002	3,298	$3,140	892	$1,076
Total		401,678	$96,225	84,598	$24,993

Source: Ag Bank, 2003
Note: All loans were made in MNT and are converted here to U.S. dollars.

In the past at the Ag Bank, there had always been a focus on conservative lending. The strategy was not to move slowly and focus on quick saturation at each branch. Rather, loan products were integrated into the branches by existing staff, who were responsible for delivering a wide array of loan products. This ensured that the right products were weighed properly in each market. Although most loans were still small trade/business loans, many new products were introduced, including loans for pensioners, herders, small and medium-sized enterprises (SMEs), employees, payrolls/consumers, and agricultural production.

The management team also made changes to the Ag Bank's deposit strategy. The new strategy was threefold: (1) increase the deposit base to fund the bank's growth; (2) increase deposit diversity by attracting a large number of diverse customers (business and consumer) to solidify the bank's franchise and strengthen its network; and (3) lessen the bank's dependence on government sources of funds.

By introducing new deposit products that met the needs of the market and providing good customer service, the bank has increased its deposit base more than 400 percent since the takeover by the DAI management team (see Table 3). This growth has in turn fueled the growth of the bank, which has become the fourth-largest bank in Mongolia based on asset size. Additionally, government deposits dropped from 52 percent of total deposits at the end of 2000 to 18 percent at the end of 2002. The bank's management also had eliminated withdrawal fees to build a solid relationship with its clients.

Table 3: Ag Bank Deposits, 2000 to 2002 ($000)

Deposit Category	12/31/02		12/31/01		12/31/00	
Business entities	$9,798	22%	$8,117	33%	$3,663	28%
Individuals	$27,028	60%	$7,752	32%	$2,520	20%
Government organizations	$8,207	18%	$8,570	35%	$6,712	52%
Total	$45,033	100%	$24,439	100%	$12,895	100%

Source: Ag Bank, 2003
Note: All deposits were made in MNT and converted here to U.S. dollars.

Loan products encouraged deposits because direct debit and credit to a current account was required for all loans. This meant borrowers had to open a current account in the bank if they were not depositors. New deposit products included personal and business current accounts, savings accounts, time deposits, pension direct deposits, and payroll direct deposits.

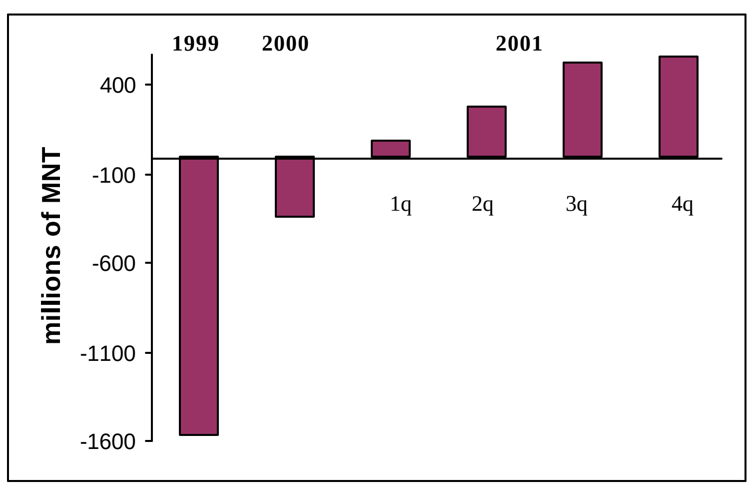
New transfer products, such as Quick Pay, Money Transfer, and Western Union, were also introduced, permitting transfers both within Mongolia and internationally. The Ag Bank expanded into the foreign currency exchange, creating a new department to handle this area. A unique, large network made the bank the best provider of nonurban foreign-funds transfers. Because the bank could move foreign funds around easily, it could meet this demand in rural areas, such as by establishing foreign exchange offices at border-crossing areas.

In order to break the existing perception of the bank as a "state monopoly" and build public trust in the bank, a major public relations campaign was launched. The aim of the marketing was to tell Mongolians that the bank was serious about its business and was open to all. A new brand and image were developed by switching the name to the initialism "XAAH," which translates to "khan" or "king," a name with strong local appeal because of Genghis Khan. This was followed by television and radio campaigns. Additionally, longitudinal market research was conducted on Mongolians' attitudes in general and to the Ag Bank in particular. This provided valuable information for preparing tailored products and services to customers and measuring the impact of the changes in the market.

A new human resources department was put in place to ensure more effective operation and less corruption. Although 75 percent of the staff were college graduates and many had long tenures at the bank and were loyal, there remained too much of a "state-sector" mentality in the bank. Therefore, all bank policies and procedures were rewritten, and significant training was conducted to reinforce the changes. Policies were aimed at creating a Western-style culture with a focus on customers and revenues, and results rather than tasks. An incentive compensation plan was initiated, with cash bonuses paid based on the bank's and the individual's performances. Moreover, the bank implemented annual employee performance evaluations that were tied to annual salary increases.

In order for the bank to sustain itself via profits and good management, its infrastructure had to be changed and its successor management trained. The head office was reorganized with new and reorganized departments, including Audit, Human Resources, International Settlements, and Special Assets departments. A new charter was developed, and a new mission statement was adopted to help motivate and focus employees:

Figure 3: Earnings before Taxes (in millions of MNT)



Source: Ag Bank, Annual Report 2001

"To be the dominant provider of financial services in the countryside and the main financial link between urban and rural Mongolia, by delivering first-class products with the highest level of customer service." The new management introduced accrual accounting and other Western standards. In the past, accounting was done by hand in aimag centers. The bank now equipped them with laptop computers and satellite communication links between the aimag branches and headquarters, allowing accounting to be done on a central server at headquarters. This innovation enabled users to access updates throughout the system immediately and made getting information about the current state of the bank and accounts much easier. Further, the bank's control system was changed by putting more power in the hands of the branches' executive teams. Finally, continuous staff training was essential to the bank's sustainability. The GTZ provided assistance in establishing a professional training department at the bank, which significantly improved the individual trainers' skills.

VII. SUCCESSFUL TURNAROUND

The Ag Bank developed targeted products, distributed them through a wide network, marketed them aggressively, raised interest rates and cut fees, trained staff, and raised wages to meet the three objectives for remediation: restore financial soundness and profitability, return financial services to the rural population, and prepare for privatization.

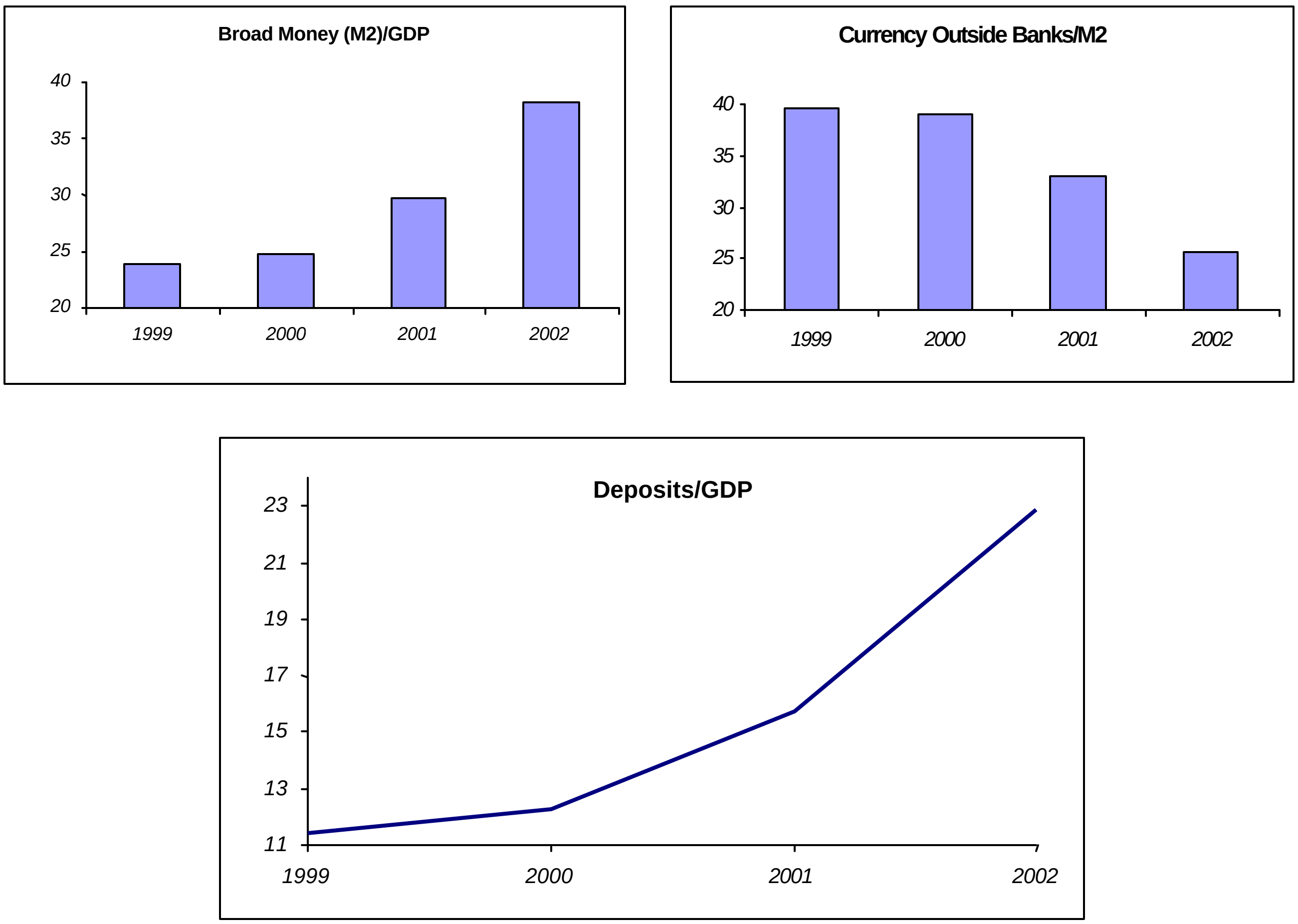
The first goal was achieved in January 2001 (see Figure 3). This was the first time since 1997 that the bank had achieved profitability, and it has maintained it ever since. Pretax earnings increased through 2001, from MNT 81 million in the first quarter to 563 million in the fourth quarter. This meant that return-on-average assets increased to 8.9 percent annually.

The bank achieved its second objective by expanding its rural network. The bank found locations where it had closed branches or never had branches, and where profits could be earned, and moved into these areas to fill the void in financial services. Indeed, one of the major tasks achieved in 2001 was remediating the aimag offices.

Finally, management succeeded in preparing the bank for privatization, its third objective. In January 2003, the government received three viable bids for the bank, all from strong and fully qualified private-sector buyers. Ultimately, the bank was sold to H.S. Securities of Japan for US$6.85 million, the highest bid. The sale closed on March 25, 2003, and the new owners have hired DAI to continue to provide management to the bank.

The bank has also contributed to the improvement of the banking sector. Unlike the early 1990s, the ratio of M2 (the broad money supply) to gross domestic product (GDP), which determines the scope of financial intermediation performed by the banking sector, has been increasing (see Figure 4). Moreover, currency outside banks as a percentage of broad money has decreased, and the ratio of bank deposits as a percentage of GDP has grown. Thus, clearly, Mongolia's banking system has improved its financial intermediation in the past few years. In its annual reports, the BOM has acknowledged the Ag Bank's role in the restoration of public confidence in rural areas. In fact, the Ag Bank's own polls show that the increase in the bank's deposits and current accountholders has come mostly from those who never used banking services before.

Figure 4: Improved Financial Intermediation, 1999–2002



Source: BOM

There are several reasons the Ag Bank has had such a successful turnaround.

First, the bank was able to negotiate and achieve its independence from the Mongolian government, obtaining the government's commitment to let the bank control itself without any political pressures.

Second, the bank was able to identify and exploit its competitive advantage. Management found that the branch system it had was the Ag Bank's franchise value. Its network of branches allowed the bank to do two things: serve the needs of the half of the Mongolian population that no other bank reached, and handle the banking needs of the government, commercial entities, and nongovernmental organizations in Ulaanbaatar that did business in the countryside. Although many branches were losing money at the time of the takeover by the DAI management team, there was little value to be gained by closing these branches because their overhead operational costs were very low. Instead, management aimed to remediate these branches and open new offices.

A third reason for the bank's turnaround was the institution's new product strategy. The bank aggressively introduced and marketed new products, both as loans and deposits. Loans were targeted and given in small amounts to many borrowers. The bank also created a new class of borrowers by recognizing that the informal lending sector was a real competitor. The bank was able to shift many borrowers to the formal financial system. Money also "moved out from under the mattress" as individual deposits grew from US$2.5 million to US$27 million from December 2000 to December 2002.

Talented staff was the fourth factor in the bank's successful recovery. Although they were unused to thinking strategically, staff were quick to grasp new products and marketing approaches and implement them. In the countryside, staff members' knowledge of local communities was essential because they knew where and how to find potential borrowers who would pay the money back.

A fifth contributor to the bank's success was management's commitment to understanding costs and cutting unnecessary expenses. Management did not cut costs right away, however; it first took the time to understand the bank's costs. Management recognized that delivering products and offering an acceptable level of customer service required certain costs and that these costs in turn would generate required revenues. On the other hand, management also realized, an increase in revenues needed to be met with the cutting of unnecessary expenses to promote profitability.

The bank was successful also because it maintained low operating costs. It did not go after high-end customers, but served the rural and low-income market segments instead. Some branches employed only two people, and in some locations hand ledgers and calculators sufficed for office equipment.

Finally, donor support was essential to the bank's turnaround. Recovery could not have occurred without USAID's participation. Other bilateral and multilateral entities, including the GTZ, also contributed significantly. International donors provided critical funds for capital improvements and technical assistance. They also helped to ensure the decision-making authority of the turnaround team. The World Bank and the Asian Development Bank played a large role in reaching an agreement with the Government of Mongolia, and USAID funded the DAI team that led the Ag Bank's turnaround.

VIII. Conclusion

The successful turnaround of the Ag Bank was a happy ending to a "unique experiment" in the Mongolian banking sector and, one hopes, the beginning of a wealthy private bank's growth in the future.

USAID approached this project in a flexible way and gave the bank's remediation a unique design. The historic state-owned bank in the countryside was put under an external management team that was given full authority to run the institution. The team pursued successful turnaround strategies that made the bank the main provider of financial services in the rural areas of Mongolia. It now has the largest branch network in the country, with 356 locations, and provides deposit and loan products in each location.

The main lesson that can be learned from the "experiment" is that a state-owned "dinosaur" bank can be and should be turned around and successfully privatized. The Ag Bank not only has become one of the largest taxpayers in Mongolia, but it also has contributed significantly to the country's overall economic development by creating more than 700 additional good-paying jobs and boosting the economy in many communities.

At the same time, the Ag Bank has provided opportunities to women in senior management positions and improved staff access to education and training. It has enhanced Mongolia's cultural life by acquiring the first art collection by a financial institution in the country featuring local artists.

The Ag Bank's success also indicates the importance of marketing. The bank's efforts in this arena, such as focused research, strong brand promotion, and products that respond to customer demand, provided the income stream that enabled the bank to grow.

The Ag Bank's recovery proves that a bank can be successful no matter what market it serves. Indeed, the bank's experience shows that targeting low-income markets can bring profits, as Mongolia's low-income populations are interested in banking services and can pay for the products and services they need. The Ag Bank's experience has shown that where per-capita income is low, there is a large market for the right kind of deposit and credit products, even if interest rates and fees are high.

In the future, the Ag Bank can exploit its extensive network and potential synergies between the surplus savings of Ulaanbaatar and other cities and the seasonal credit needs of the rural areas. The bank can diversify its credit risks, expand its city-based operations, and balance its city operations with its rural ones. In that way, the now-privatized Ag Bank can have a profitable and successful future.

In June 2000, USAID took some risks in getting involved in an insolvent institution, but three years later, through effective management and the right approach, the agency has ended up with an aid project that has achieved more than the intended results.

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